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Japan’s negative interest rate gamble

By Dan Steinbock | February 2, 2016, Tuesday | PRINT EDITION The story appears on **Page A7**

Instead of boosting growth, the Bank of Japan's negative interest rates will contribute to domestic fiscal deterioration, regional risks, even global threats.

About a week ago, the Bank of Japan’s (BOJ) governor Haruhiko Kuroda said to the parliament: “We are not considering a cut in interest on bank reserves.”

True, the European Central Bank (ECB) has embraced negative interest rates. Its chief Mario Draghi has had few other options since 2011 when he promised to defend the euro “at any costs.” In contrast, Kuroda, despite his penchant to surprise the markets, emphatically ruled out negative rates.

And yet, last Friday Kuroda announced that the BOJ would impose a 0.1 percent fee – a negative interest rate – on deposits from commercial banks.

Some argue that the decision was an effort to contain the adverse impact of the resignation of Economy Minister Akira Amari, the father of Abenomics, over corruption allegations.

Nevertheless, Kuroda's reversal shocked the financial markets. And there is worse ahead.

Massive liquidity bet

After two lost decades, Japan began a risky monetary gamble in 2012-13 when Shinzo Abe and his Liberal Democratic Party (LDP) returned to power. As the bold Kuroda succeeded the conservative Masaaki Shirakawa as the BOJ chief, he pledged to do “whatever it takes” to achieve the 2 percent inflation target.

The BOJ began open-ended asset buying hoping to inject US$1.4 trillion into the Japanese economy in just two years. The massive liquidity gamble went hand in hand with Prime Minister Abe’s reform agenda of renewed fiscal stimulus, aggressive monetary easing and proposed structural reforms - and participation in the US-led Trans-Pacific Partnership (TPP) to speed up reforms at home.

Inspiringly, he initially also pushed for greater role of women in the labor markets, whereas immigration reforms linger, even though Japan’s population is aging fast and the population base is on decline.

After one year of fiscal stimulus, Abe pledged fiscal consolidation in 2014; far too early. At the time I predicted that markets would love Abenomics in 2013, but a backlash would ensue in 2014 - which is precisely what happened.

Instead of using fiscal accommodation to strengthen Japanese consumption, Abe went ahead with the consumption tax hike even though the recovery was too fragile for consolidation.

Moreover, adequate demand was further undermined by LDP’s ultra-conservative politics, which alienated social liberals; a controversial secrecy bill that reduced the privacy of ordinary Japanese; and the mitigation of Japan's historical pacifism and the concomitant rearmament, which has contributed to rising geopolitical tensions with China.

As Abe’s politics undermined his economic goals, his approval ratings plunged and Japan slid into recession.

Deterioration of fiscal discipline

Last year saw more muddling through and, in the 4th quarter of 2015, growth amounted to 0.3 percent. While Tokyo could still achieve 1.4 percent expansion in 2016, consumption growth is subdued, wage talks are not likely to boost real wages and inflation lingers far below the target.

Japan’s notorious debt burden shows no signs of easing either. Even though sovereign debt is close to 250 percent of its GDP, the BOJ has accelerated its asset-buying program.

Today, the ECB’s balance sheet is 25 percent of the Eurozone GDP; the same as the US Fed’s level at its highest in 2014. In both Washington and Brussels, rounds of quantitative easing has resulted in divisive political debates.

In contrast, the BOJ’s balance sheet is already 80 percent of the Japanese GDP; in relative terms, more than three times higher than in the US and the Eurozone. What's worse, it is growing by 16% annually. As a result, the BOJ must pay its rates on a far larger quantity of bank assets.

Instead of caution, Japan's institutional investors joined the gamble over a year ago when the US$1.2 trillion Government Pension Investment Fund (GPIF), which controls the retirement incomes of some 67 million Japanese, said it would take more aggressive bets by reducing funds in domestic bonds while pumping up its investments in stocks. Intriguingly, while other global pension funds struggle to minimize holdings in risky assets, GPIF is boosting such investments.

Meanwhile, the BOJ has boosted its asset-buying program drastically by going far beyond what the U.S. Fed and other central banks have bought in their stimulus programs and blurring the notion of risk. Nevertheless, a sense of crisis remains absent in Tokyo.

Unlike Greek debt, Japanese debt is mainly in domestic currency. As a result, most Japanese continue to have confidence in yen. However, the arrival of negative rates suggests that this faith may prove misguided.

Elevated regional risks, elevated global threats

Domestically, negative interest rates will amplify uncertainties. First, if banks prove reluctant to sell Japanese government bonds that would undermine the BOJ's asset purchases. Second, the BOJ's negative rates will further reduce the profitability of the banking system, particularly the weaker and politically sensitive regional banks.

As the world's third-largest economy, Japan's negative rates are likely to increase downside risks internationally and will complicate the Fed's proposed rate hikes in 2016. In Asia, central banks already have an easing bias, due to disinflation and stagnation in advanced markets.

The currency implications are a different story. When Abe came to office in fall 2012, US dollar amounted to less than 80 yen; today, it is over 120 yen. In four years, the yen has halved relative to dollar. Thanks to continued asset purchases, lingering deflation and negative rates, depreciation will continue. That is unleashing fears of new 'currency wars' in a region where export-led growth has historically relied on competitive currencies - particularly in nations, such as South Korea, which tend to compete in overlapping industries and with parallel strategies.

Japan's largest export partners include the US, China, Australia, South Korea and Thailand, while its foreign investment is mainly in the US, China, UK and Singapore. Recently, all of these partners have been struggling with diminished prospects. With 0.7 percent growth in the last quarter, US recovery is slowing, while China's slower growth and Abe's geopolitics weighs on Japanese export growth.

Conversely, if Japan is swept by a crisis, its trade and investment partners will suffer collateral damage. That would prove particularly painful in emerging Asia that is most exposed to Japanese aid, including Myanmar, Vietnam and the Philippines.

Despite rising downside risks, domestic opposition is powerless in Japan, due to LDP's recent electoral consolidation. Externally, Washington is unlikely to intervene because it needs Tokyo for its geopolitical pivot in Asia. Consequently, Japan's fiscal and monetary deterioration is likely to continue, even though adverse spillovers may spread regionally, even globally.

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